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SUBJECT: PAKISTAN'S SHARIAT COURT BANS SHORT SELLING ON STOCKS

¶1. (SBU) Summary: In October, the Federal Shariat Court of Pakistan, a court traditionally concerned with social matters, expanded its jurisdiction into the economic realm by directing the government to amend its financial laws within six months to impose significant penalties on those who engage in short selling. The Court declared that the practice violates the injunctions of Islam due to its "speculative nature and underhand dealings." A ban on short selling, if enforced, could deter investment in the already battered Karachi Stock Exchange (KSE) but would probably have no more than a minor effect on Pakistan's fragile economy. Short selling - the risky practice of selling a financial instrument that the seller does not own at the time of the sale - is controversial. But economic judgment tends to expose the problems with short selling more lucidly than religious decrees. Expanded Islamic regulation of economic behavior could reduce consumer choice and shrink markets, heralding a troubling precedent. End Summary.

Shariat Court Expands its Jurisdiction to Economic Realm

¶2. (U) The Federal Shariat Court of Pakistan initiated a case in 1987 examining whether short selling was Islamic, exercising its independent powers to investigate a matter ("suo moto"). The court consists of a Chief Justice and four judges. While the Federal Shariat Court does not have jurisdiction over cases relating to civil and public laws, under Pakistan's constitution, it is permitted to take up laws and shape them in accordance with the Quran and Sunnah. The court has rarely ruled on economic matters, traditionally focusing on social matters. But the October decree reflects a rising tide of ideology in Islamic financing and appears to expand more aggressively its jurisdiction into the economic realm.

Shariat Court Rules Short Selling Violates Islam

¶3. (U) For 21 years, the Federal Shariat Court conducted hearings on the permissibility of short selling. Although the Companies Ordinance, 1984, explicitly prohibits short selling, many traders have been ignoring the law because it imposes no punishment on violators. Short selling has been halted for brief periods before, most recently in June. Thus, short selling exists in Pakistan, but under clandestine arrangements. The court invited parties such as Pakistan's Ministry of Finance, the Banking Council of Pakistan, the Securities and Exchange Commission, the four provincial governments, and Ulema (religious scholars) to voice their opinions. The religious court's 57-page ruling, issued on October 24, declared that short selling violated Islamic principles. The KSE Board has announced its intent to appeal to the Shariat court's ruling to the

Supreme Court of Pakistan.

What is Short Selling?

¶4. (U) Short selling is a controversial and risky practice done with the intent of buying the financial instrument at later date at a lower price, in an attempt to profit from an expected drop in the price of a financial instrument. Typically, the short-seller will "borrow" or "rent" the securities to be sold, and later repurchase identical securities for return to the lender. If the security price falls as expected, then the short-seller profits from having sold the borrowed securities for more than he later pays for them. But if the security price rises, the short seller loses by having to pay more for them than the price at which he sold them. The practice is risky because prices may rise indefinitely, even beyond the net worth of the short seller. Although the practice is risky, it is an accepted part of modern economic trading and in most cases, adequate market data allows investors to make their own assessments.

A Ban on Short Selling Could Deter Trading in Pakistan

¶5. (SBU) The edict, if implemented by the court's April 2009 deadline, would primarily affect Pakistan's largest equity market, the KSE. Banning short selling limits the tools available to investors, discouraging speculation but also impairing legitimate hedging. More importantly, the ban could reinforce the perception among investors that Pakistan is an over-regulated economy, and that the Federal Shariat court may expand its foray into economics with

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further decrees. Pakistan may be seen as a less attractive destination for foreign capital which would further harm its already fragile economy.

Comment:

¶6. (SBU) The Shariat Court's decree could herald expanded Islamic regulation of economic behavior, setting a troubling precedent. The Federal Shariat Court's 57-page decision imposing a ban on short selling contains no economic analysis, in spite of 21 years of deliberation and consultations with GOP economic officials. The decision did not cite any independent economic experts. The ruling is obtuse because the first 49 pages of the decree deals with irrelevant historical background, only one paragraph announces the court's opinion on the specific issue of short selling, and the decree provides no analysis to justify its conclusion, regardless of the validity of the conclusion itself under Islamic theology. Many average Pakistanis are sufficiently versed in Islamic jurisprudence and modern economics to competently formulate counterarguments to the religious court's reasoning. Many Pakistanis will simply ignore the court. But if Islamic regulation of economic behavior via court decrees like this expands, then Pakistan's fragile economy could be harmed. End Comment.

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